Philippine Economic *Outlook*

JUNE 2005

Inside...

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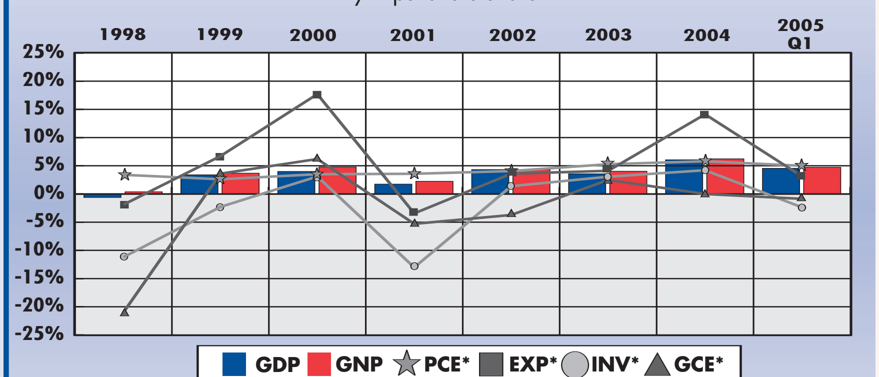
Summary and Introduction

The Philippines faced a challenging economic environment domestically and externally in the first half of 2005: high and volatile world oil prices, unfavorable weather conditions, slower growth in export markets, and upward pressure on foreign interest rates. Although necessary for longer-term macroeconomic stability, legislated revenue measures will add to price pressures and to uncertainties over short-term economic growth prospects. Philippine Gross Domestic Product (GDP) expanded by 6.1% year-on-year in 2004 (a 15-year high) but slowed to 4.6% year-on-year growth during the first quarter of 2005, below the Government's 5.3%-6.3% targeted range for the full year.

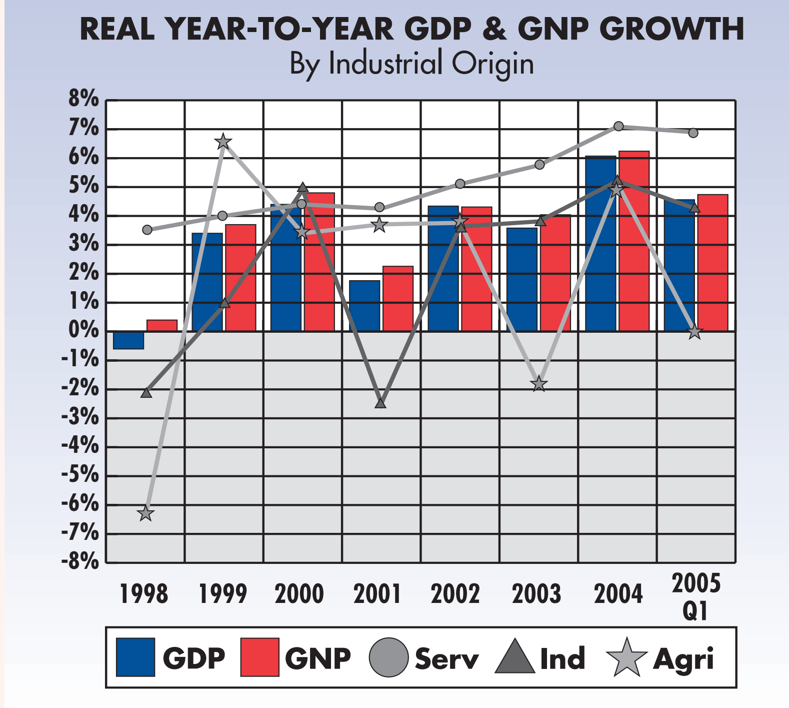
Although economic growth will slow during 2005, a number of positive developments helped push up the peso, the stock market, and the balance of payments during the first five months of the year. On the fiscal front, the National Government is on track to reducing its budget deficit for a third consecutive year. The Government has taken further steps to implement market-based pricing for the electricity sector that will help improve the dire financial condition of the Government's National Power Corporation and reduce the consolidated public sector deficit. In December 2004, the Philippine Supreme Court upheld the constitutionality of up to 100% foreign ownership in mining exploration activities, helping to revive investor interest in the sputtering mining industry. In recognition of the Government's anti-money laundering efforts, the Financial Action Task Force removed the Philippines from its watch list of Non-Cooperative Countries and Territories during its

REAL YEAR-TO-YEAR GDP AND GNP GROWTH
By Expenditure Share



***PCE (Personal Consumption Exp.); GCE (Gov't Consumption Exp.); INV (Fixed Capital Investments); EXP (Exports of goods and non-factor services)**

February 2005 plenary meeting. Business process outsourcing continues to grow rapidly due largely to the Philippines' large English-speaking workforce. On track to hitting or breaching the $9.5-billion mark in 2005, annual remittances from overseas Filipino workers (OFWs) are helping to cushion a slowdown in private consumption and boost the country's non-debt sources of foreign exchange reserves.



President Macapagal-Arroyo has repeatedly cited addressing the precarious state of public sector finances as her Administration's most pressing challenge. Shortly after her inauguration, she called on the Philippine Congress to pass legislation to raise at least P80 billion in additional annual revenues. Between December 2004 and May 2005, the President signed into law measures raising excise taxes on tobacco and alcohol products, instituting a lateral attrition system in revenue collection agencies and, most recently, amending the Philippines' Value Added Tax law. The Government is depending heavily on these revenue measures — most especially on incrementally increased Value Added Tax collections — to reduce deficit and debt levels more aggressively while preventing a further squeeze on expenditures for infrastructure and other vital social services. Credit rating agencies have thus far responded to the recent enactment of the amended Value Added Tax law with cautious optimism, pending clearer indications of a sustainable fiscal and debt turnaround.

Despite this array of positive news, the Philippines continues to face important challenges to achieving and sustaining a higher growth path that will mitigate poverty and address high unemployment. First, the country may face a period of political tensions with likely further Congressional investigations into allegations that the President's family received funds from illegal gambling and the release of an audio tape purporting to contain a conversation between the President and an Election Commissioner regarding obtaining specified vote margins for the May 2004 election. This could make it more difficult for the Government and Congress to focus on necessary actions to attract higher levels of local and foreign investment, which is crucial to achieving developmental goals, improving the inadequate state of Philippine infrastructure, and sustaining a higher rate of economic growth. Investors continue to express concerns about law and order, corruption, the unpredictable legal and regulatory environment, and a fractious political climate. Domestic savings and investment rates are among the lowest in the region. The Philippines — which had prided itself as the regional economy least adversely affected by the Asian financial crisis — is now struggling with declining international competitiveness and worsening corruption rankings in a global environment of increasingly fiercer competition for trade and capital. Although improving, banking sector credit growth remains moderate thus far, with more progress required to address the overhang of non-performing assets. The capital market is underdeveloped and dominated by Government securities. The Central Bank continues to push for important legislative amendments that will strengthen its supervisory and prompt corrective action powers.

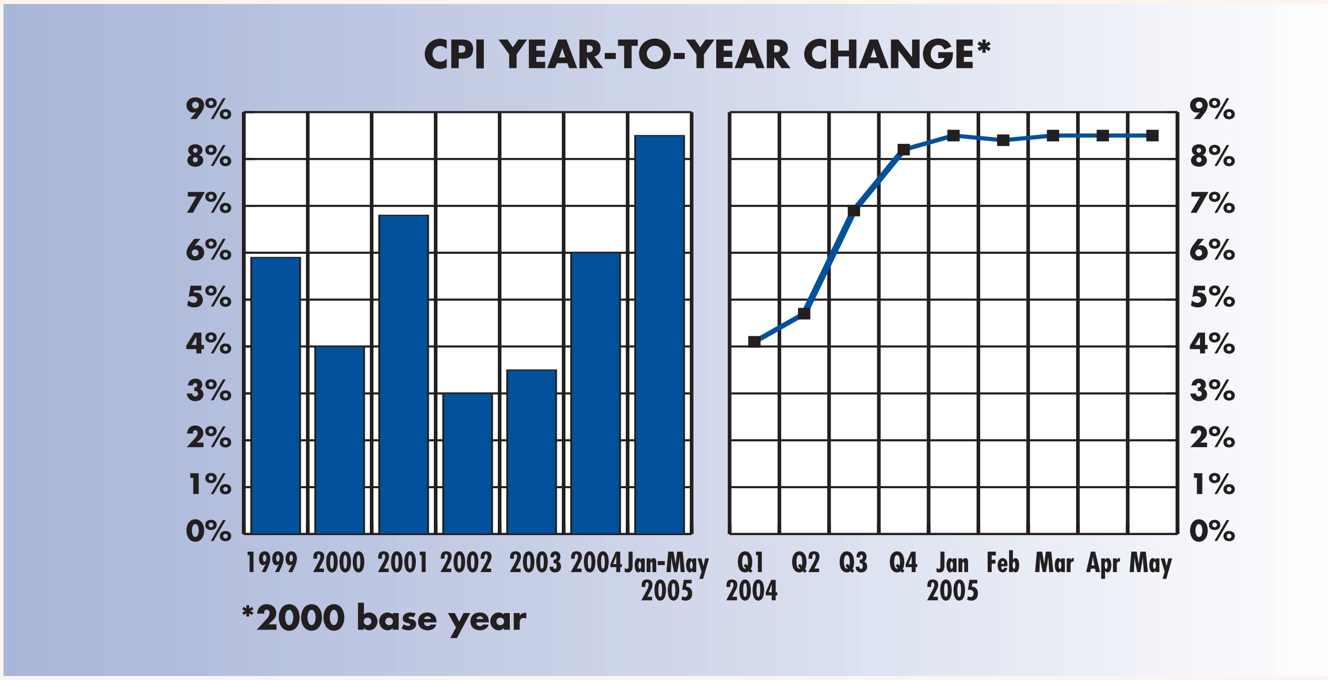
This year and next, credit rating agencies, investors, and other Philippine observers will closely monitor whether fiscal reform measures indeed bear fruit. Fiscal stabilization will continue to require strong political will, including persistent efforts to address high tax evasion/leakage rates, and remains a crucial gauge of the Government's commitment to broader reforms. Respected economists stress that the Philippines is at a make-or-break crossroad in its fiscal history. The amended Value Added Tax law was particularly controversial and the Government will be hard-pressed to show concrete results to appease public resistance to new and/or higher taxes. Effective collection and implementation will be key to achieving envisioned longer-term macroeconomic gains from painful but necessary fiscal measures.

Economic Growth and Inflation

Philippine Gross Domestic Product (GDP) closed 2004 up by 6.1% from 2003, the strongest year-on-year expansion in 15 years. The economy benefited from favorable weather and strong global demand. However, economic growth has since slowed with less favorable weather conditions, persistent inflationary pressures, and moderate global demand.

According to the latest national income accounts, first-quarter 2005 GDP expanded by 4.6% from the first quarter of 2004, well below the Government's full-year targeted range of 5.3%-6.3%. Real Gross National Product (GNP) expanded by a slightly higher 4.7%. Net factor income from abroad expanded by 6.7% year-on-year, somewhat slower than in the first quarter of 2004 (7.0%) as lower property-related incomes partially offset stronger remittances from OFWS.

On the supply side, first-quarter 2005 agricultural output stagnated at the first-quarter 2004 level as a succession of late year 2004 typhoons and the onset of El Niño adversely affected agricultural harvests. Industrial sector output (up by 4.2%) slowed somewhat from its first quarter 2004 performance (4.7%). A 4.4% contraction in the mining and quarrying sub-sector, attributed to lower production of gold and non-metallic minerals, partially offset the stronger growth rates posted by manufacturing (4.2%), utilities (5.6%), and construction (7.9%).



On the demand side, personal consumption slowed from 5.7% year-on-year growth during the first quarter of 2004 to 5% growth during the first quarter of 2005, as consumers grappled with rising inflation. Remittances from OFWs helped cushion a sharper slowdown in consumer demand. Reflecting the global economy's more moderate expansion, Philippine exports of goods and non-factor services increased by a modest 3.1%, a marked slowdown from the 11.6% year-on-year increase logged during 2004's first quarter. Government consumption declined by nearly one percent in real terms as the Government pursued austerity measures in line with continuing efforts to reduce the public sector deficit.

Expectations of weaker demand and the rising cost of business operations have resulted in more conservative investments in durable equipment and inventories. Gross capital investments (which increased by 7.7% during the first quarter of 2004) declined by 4.1% during the first quarter of 2005, reflecting lower fixed capital expenditures and inventory build-up from the previous year. Investments in construction grew by 5.6% year-on-year after a slight contraction during 2004's comparable quarter. However, weaker outlays for durable equipment (which declined by 7.5%) pulled down overall fixed-capital spending during the period.

Service sector output, which contributes close to half of Philippine GDP, increased by 6.9% year-on-year during the first quarter of 2005, versus 6.6% growth during the first quarter of 2004. Finance, transportation and communications, and real estate drove the service sector's stronger performance, making up for the slower rates of expansion posted by trade (consistent with the slowdown in consumer spending), private services, and government services. Although credit growth remains moderate, the growth of financial services accelerated from 7% (first quarter 2004) to over 11% (first quarter 2005), as banks pursued fee-based sources of revenues more aggressively. From 9.2% year-on-year growth during 2004's first quarter, the transport and communications sub-sector expanded by 9.6% during the first three months of 2005, driven mainly by the continued robust demand for mobile communication and the rapid expansion of call centers and business process outsourcing (BPO) services. The expansion of call centers and BPO services contributed to the strong first quarter growth of the real estate sub-sector, which accelerated to 6.8% from 4.0% in the first quarter of 2004.

The Government remains hopeful that the economy will be able to hit at least the low end of the 5.3%-6.3% growth range targeted for full-year 2005, but there are downside risks to achieving that goal. Although agricultural output likely will improve during the second half of the year, it may fall short of the Government's 4.0%-4.4% targeted growth for the full year. Businesses are struggling with weaker-than-expected domestic and external demand, while fuel and utility rate hikes and impending wage increases will further raise operating costs. Although necessary to boost revenues, the amendments to the Value Added Tax (VAT) law have added uncertainty to short-term economic growth prospects. (See special feature on *The Amended Value Added Tax Law: A Bitter Fiscal Pill* on page 10.) Full-year GDP should expand in the 4.7%-5.1% range.

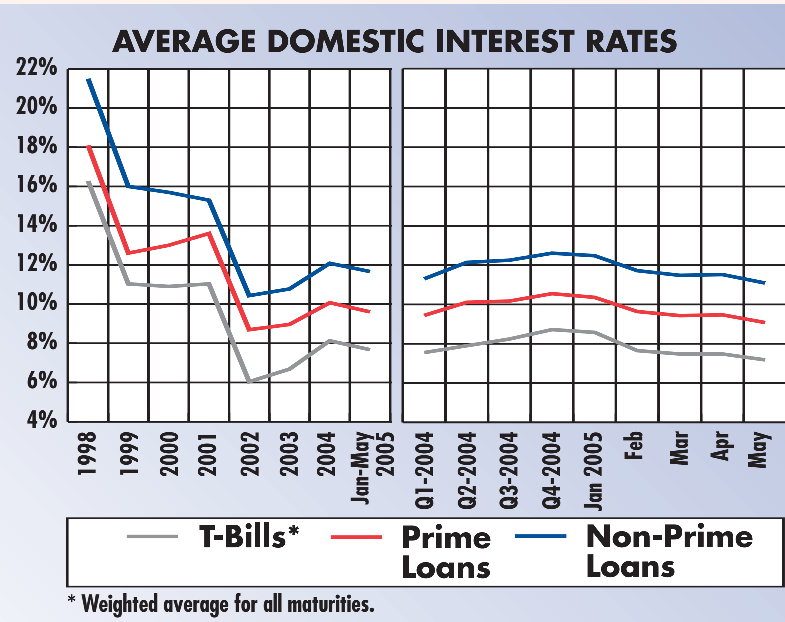
A number of supply-side pressures on food prices, successive fuel price hikes, and electricity rate adjustments pushed up consumer inflation during 2004. From 3% during 2003, year-on-year inflation averaged 5.5% during 2004 based on the 1994 consumer price index (CPI), breaching the Government's 4%-5% target for the year. Based on the 2000 CPI that the Government began phasing in during 2004, year-on-year inflation averaged 6%, climbing from 4.1% in January to 8.6% by December. Average inflation will accelerate further in 2005 and exceed the Government's 5%-6% target (2000 CPI) as high oil prices, impending wage increases, further electricity-rate hikes, and petitions for adjustments in regulated public transport fares have an impact on general price levels. Government economic planners estimate that the recent amendments to the VAT law could add from one-half to a full percentage point to 2005's average inflation rate. Year-on-year inflation averaged 8.5% during the first five months of 2005, with El Niño contributing further to upward price pressures, although inflation may moderate during the second half of the year as prices come off a higher 2004 base. Current forecasts place the 2005 inflation rate at 7.5%-8.0%.

Labor and Employment

The Philippine unemployment rate increased by 0.3 percentage points, from 11.0% in January 2004 to 11.3% in January 2005, but below the average 2004 rate of 11.8%, based on quarterly surveys conducted by the National Statistics Office. In 2003, the average unemployment rate had been 11.4%. The marginal decline in the jobless rate for January 2005 was attributed mainly to the decrease in the labor force participation rate, which fell to 66.1% from 67.3% for the same period last year. The 3.5% decline in wage and salary employment, 1.1% decline in full-time employment, and 18.4% expansion in the number of unpaid family workers further contributed to the weakness in the labor market. The ratio of those engaged in part-time work increased by 2.1% to 62.6% this year. Growth in part-time employment exceeded growth in full-time employment for the same period.

Participation in the labor force reached 35.66 million in January 2005 from 35.45 million in January 2004, an increase of only 6%. This is the lowest incremental increase in the labor force recorded in recent years. The underemployment rate (ratio of those people working less than 40 hours a week or considered visibly underemployed) fell to 16.1% from 17.5% a year ago.

The number of employed persons increased by only 87,000 between January 2004 and January 2005, from 31.55 million to 31.63 million, respectively. The only sector that



posted employment growth was the agriculture, fishery, and forestry sector (up 1.7%). The industry and service sectors suffered a loss of 1.4%.

The National Conciliation and Mediation Board registered 99 notices of strikes/lockouts for the first quarter of 2005, compared to 150 cases filed in the same period last year. This year's first quarter notices covered fewer workers (15,479) compared to the first three months of 2004 (27,450).

As of early June 2005, ten of the 16 Regional Tripartite Wages and Productivity Boards (RTWPBs) had announced increases in minimum wages. The announcements came after President Macapagal-Arroyo, on Labor Day, ordered the Department of Labor and Employment (DOLE) to convene the RTWPBs to come up with appropriate adjustments in the minimum wage. The RTWPB in the National Capital Region approved a P25 increase from the current minimum wage of P250 pesos. The other nine RTWPBs approved increases in daily wages ranging from P11 to P20.

Financial Markets

As of May 2005, the Philippine Monetary Board — the highest policy-making body of the Bangko Sentral ng Pilipinas (BSP, the Central Bank) — had adjusted policy rates only once despite eight successive increases in the target U.S. federal funds rate since June 2004 (totaling 200 basis points). Citing soft spots on the demand-side — among them the country's high unemployment rate, remaining spare capacity in the manufacturing sector, and moderate credit growth — the Monetary Board blamed supply-side, cost-push factors for spurring inflation to defend its generally neutral policy stance. The Monetary Board raised the BSP's overnight borrowing and lending rates by 25 basis points in early April 2005 to 7.0% and 9.25%, respectively, as a preemptive measure against heightened inflation expectations from high and volatile oil world prices. The Monetary Board refrained from further adjustments in May despite another 25 basis-point increase in the target federal funds rate by the U.S. Federal Open Market Committee (FOMC).

Interest rate differentials, while tightening, remained sizeable until December 2004, with the gap (net of tax) between the Philippine Government's 90-day Treasury bill and the United States' 90-day paper and 90-day LIBOR estimated at 384 and 373 basis points, respectively. However, those differentials have since narrowed more markedly, reflecting a combination of rising foreign interest rates and softening domestic rates. By May 2005, the gap between the Government's 91-day paper and comparable U.S. Treasury bills and LIBOR had narrowed to under 250 basis points.

Bid rates for Government securities rose during 2004, reflecting political risk premiums in the run-up to the June 2004 elections, rising inflation expectations, and concerns over the public sector's precarious fiscal condition. The loan-benchmark 91-day Treasury bills averaged 7.34%, up by 131 basis points from 2003. Rates softened during the first five months of 2005 on more encouraging fiscal developments. The Government's 91-day Treasury bills averaged 6.76% during that period, with rates during the Government's last two auctions in May 2005 declining to under 6% for the first time since October 2003. Although nominal rates increased during 2004, real interest rates (i.e., nominal rates less inflation) for the 91-day bills narrowed to 1.34%, nearly half 2003's 2.53% average. Real interest rates for the Government's 91-day paper hit negative territory in November 2004 (-0.33%) and averaged -1.74% during the first five months of 2005. With bank lending still struggling to recover and economic growth expected to slow, the declining real yields for government securities also reflect strong demand for relatively risk-free investment alternatives.

Prime loan rates offered by the banking sector averaged 10.07% during 2004, up 115 basis points year-on-year. Average loan rates for non-prime customers increased by 133 basis points to 12.08%. However, average real interest rates narrowed from 5.42% (2003) to 4.07% (2005) for prime borrowers and from 7.25% to 6.08% for non-prime borrowers. Nominal lending rates have since softened somewhat, with nominal prime loan rates averaging 9.60% and non-prime rates 11.66% during January-May 2005. Average real interest rates for prime clients narrowed to 1.10% during that five-month period and for non-prime borrowers to 3.16%. Looking forward, narrowing differentials vis-à-vis international interest rates (which poses risks of investments shifting from peso to foreign assets), tightening real yields, and further inflationary pressures suggest that domestic interest rates, especially for the shorter end of the yield curve, may be bottoming out. However, improved public sector finances and the moderate demand for credit are likely to temper upward interest-rate pressures.

Outstanding loans of the commercial banking system (net of inter-bank credits) expanded by 3.3% year-on-year in 2004. As of March 2005, loan growth had accelerated to 5.5% but remained far from the robust two-digit rates before the Asian financial crisis. The modest credit expansion reflects a combination of weak loan demand, banks' aversion to credit risks, and the preference for government securities. Although improving, the overhang of non-performing assets (NPAs, the sum of non-performing loans and foreclosed assets) and the accompanying need to beef up loan loss reserves continue to inhibit more aggressive credit growth, constrain capital build-up, and exert pressure on banks' bottom lines.

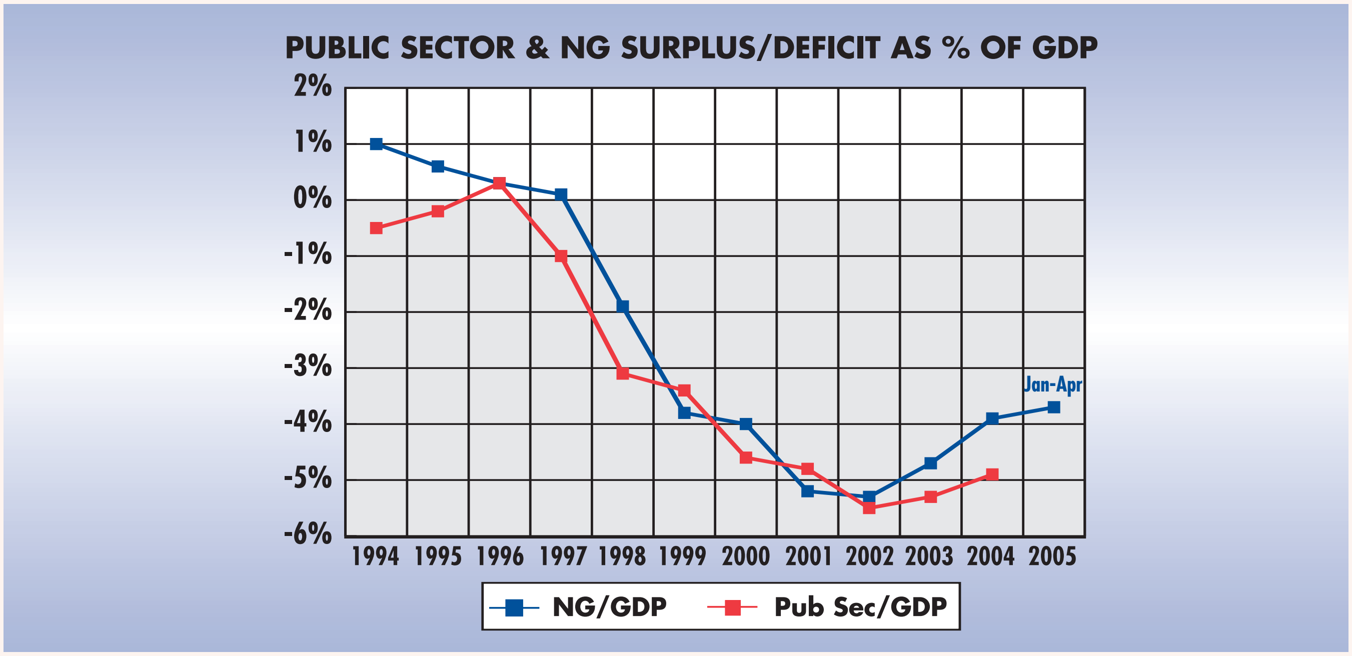
The Special Purpose Vehicle (SPV) Act of January 2003, which provides time-bound fiscal and regulatory incentives to encourage the sale of NPAs to private asset management companies, is helping to reduce banks' NPA portfolios. Banks had until April 12, 2005 to conclude notarized agreements to sell their NPAs to qualify for incentives under the law. As of March 2005, the commercial banking system's NPAs had declined by 10.1% (P45.5 billion) year-on-year to P402.5 billion. Non-performing loans (NPLs), estimated at P207.2 billion as of March 2005, contracted by a cumulative 15.6% (P38.3 billion) from the end of 2003. The ratio of NPAs to gross assets declined from 12.9% at the end of 2003 to 10.1% at the end of March 2005 and the ratio of NPLs to total loans from 14.1% to 11.3% over the same period. The BSP estimated that distressed assets (NPAs plus restructured loans) equaled 12.3% of total commercial banking system resources as of March 2005, an improvement from the end of 2003 (14.9%) but still well above the less-than-5% ratio before the Asian crisis.

More NPAs are expected to be unloaded under the SPV Act over the next few months. Since the enactment of the law until May 20, 2005, the BSP had issued 215 certificates of eligibility (COEs) to 34 banks and non-bank financial intermediaries to unload P58 billion worth of NPAs, P45 billion of which represented sales to SPVs and the remaining P13 billion "dacion en pago" (payment-in-kind) arrangements and sales of foreclosed residential units to individual buyers. The BSP is processing another P45.7 billion of applications from 22 banks. Overall, the BSP estimates that the SPV Law will have helped banks resolve NPAs with a total book value of about P103.7 billion when the sales agreements have been fully implemented. Still, that amount represents barely one-fifth of the more than P500 billion NPAs of the Philippine banking system before the law was signed. A bill supported by the BSP and the Bankers Association of the Philippines that seeks to extend the deadline for incentives under the SPV framework beyond April 2005 is awaiting plenary discussions in the Philippine Congress.

Computed according to the Basel Capital Accord formula, Philippine commercial banks' published average capital-adequacy ratio has been estimated at 18.4% (on a consolidated basis) as of end-September 2004, better than the BSP's 10% statutory floor and the 8% internationally accepted standard. Provisions for probable losses increased from 32.2% of NPAs as of end-March 2004 to 37.4% as of end-March 2005. However, significant troubles at any major commercial bank could lead to a swift reversal of depositor sentiment, and the resulting strain on the system to service withdrawals could be substantial. About 373 banking institutions (including 14 commercial banks) are saddled with NPA ratios exceeding the industry average. Several banks (nine commercial banks, 31 thrift banks, and 147 rural and cooperative banks) remain short of BSP-prescribed minimum capitalization levels. More than 160 banking institutions (including one commercial bank) have yet to comply with the BSP's 10% capital adequacy ratio.

The BSP continues to encourage consolidation in the banking system through time-bound incentives and a temporary moratorium (since September 1999) on the issuance of new bank licenses. During 2004, there were four completed acquisitions/mergers involving two thrift banks, seven rural banks, and two offshore banking units. One more merger had been completed as of April 2005 (involving three rural banks). The BSP has approved 56 acquisitions, mergers and/or consolidations thus far since the Asian crisis (involving 29 commercial banks, 23 thrift banks, 30 rural banks, nine non-bank financial intermediaries, and two offshore banking units), 54 cases of which had been completed as of end-April 2005. The inability of a number of banking institutions to meet minimum capitalization levels suggests there is room for further consolidation. Another ten acquisition and/or merger proposals are pending BSP approval. Lower-capitalized thrift and rural banks, which constitute less than 10% of overall banking system assets, have been more severely affected by the shakeout since the Asian crisis. Four banks (two thrift banks and two rural banks) were closed during 2004 and another seven banks were closed during the first four months of 2005 — for a total of 154 bank closures since mid-1997 (involving two commercial, 19 thrift, and 133 rural and cooperative banks).

The Bangko Sentral ng Pilipinas continues to work fully to implement the General Banking Law of 2000, which is geared towards strengthening transparency, bank management, and bank supervision. The BSP has issued several guidelines to widen the application of Basel-prescribed, risk-based capital adequacy standards, enhance risk-based management and supervision systems, and to protect investors through third-party securities custodianship and registry requirements. The BSP has also announced that it will be working fully to adopt Basel 2 standards by 2007, which, inter alia, would expand coverage from credit and market risks to operational risks, as well as enhance the risk-weighting framework. Nevertheless, the circumstances surrounding bank closures highlight remaining impediments to more effective bank supervision and timely intervention — including stringent bank secrecy laws, obstacles preventing bank regulators from examining banks at will, and inadequate legal protection for BSP officials and bank examiners. The Central Bank is pushing for amendments to its charter to strengthen its regulatory, supervisory, and prompt corrective action powers — including authority to compel weak banks to infuse additional capital, accept new investors, or merge with stronger financial institutions.



On the anti-money laundering front, a team from the Paris-based Financial Action Task Force (FATF) visited Manila in January 2005 to conduct an on-site evaluation. The FATF subsequently removed the Philippines from its list of Non-Cooperating Countries and Territories (NCCTs), noting the significant progress made to remedy concerns and deficiencies identified by FATF and to improve anti-money laundering efforts. FATF will continue to monitor implementation of the Philippines' anti-money laundering law to ensure that NCCT-delisted countries sustain their recent progress. In a move to further strengthen the fight against money laundering, the BSP issued a circular in late January 2005 to bring loosely regulated foreign exchange dealers/money changers and remittance agents under BSP supervision and monitoring for compliance with the Anti-Money Laundering Act (AMLA). These enterprises are now required to register with the BSP in order to operate and must comply with various BSP regulations and circulars related to the implementation of the AMLA.

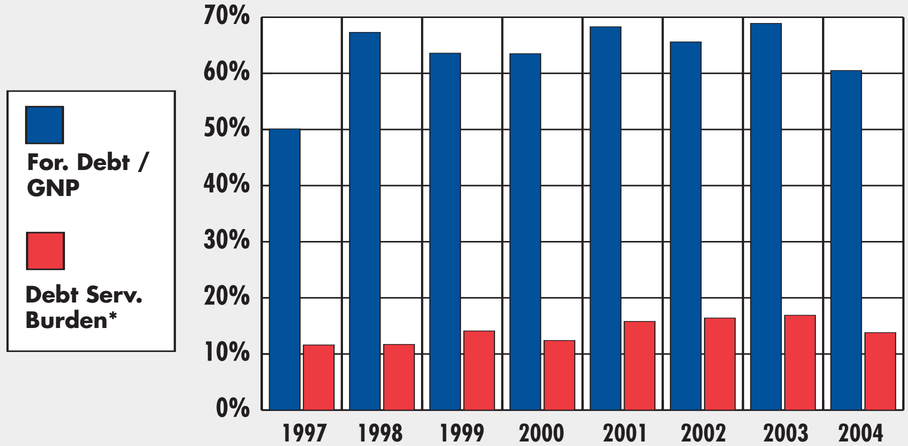
The Egmont Group, the international network of financial intelligence units (FIUs), admitted the Philippines to its membership in June 2005. A number of counter-terrorism bills, including one crafted by a technical working group composed of both legislative and executive branch members, are circulating in the Philippine Congress, although the AMLC believes that existing laws/penal codes provide sufficient legal basis to combat terrorist financing. The committees on Justice and on Foreign Affairs held the first joint hearing on the proposed legislation in June.

The Philippine Stock Price Index (Phisix) recovered from a shaky 2004 first quarter despite accelerating inflation and intermittent fiscal concerns as election-related jitters ebbed, publicly-listed companies logged better-than-expected earnings, interest rates rose at a measured pace, and Philippine economic growth accelerated. The Phisix hit 1,851 on October 4, 2004, its best performance in more than 4-1/2 years, before tapering to a year-end level of 1,822, up 26.4% from the end of 2003. The Phisix rose further during the first quarter of 2005 to close at 2,166 on March 7, the highest in 5-1/2 years. A number of Initial Public Offerings worth P33.6 billion and a succession of encouraging news — such as the passage of new revenue laws, passing marks from the California Public Employees' Retirement System's (CalPERS) for the Philippines' retention in its investment roster, a Supreme Court decision upholding the legality of up to full foreign participation in mining ventures, and the Philippines' removal from the Financial Action Task Force's money laundering watch list — overshadowed a new round of credit rating downgrades. In the absence of fresh major leads, the Phisix has since lost most of its recent gains, reflecting heightened inflation worries, concerns over the interest-rate outlook, and uncertainties over the economic and business impact of recently enacted amendments to the Philippines' Value Added Tax law. The Phisix nonetheless closed May 2005 at 1,929, up 5.8% from the end of 2004.

Fiscal Performance

For a second consecutive year in 2004, the National Government (NG) fiscal deficit declined. From 2002's record P210.7-billion (5.3% of GDP) level, the NG deficit fell to P199.9 billion (4.7% of GDP) in 2003 and narrowed further to P187.1 billion (3.9% of GDP) in 2004, P10.7 billion below the P197.8-billion budget gap programmed for the year. Revenues increased by P73.2 billion to P699.8 billion year-on-year (11.7%) and surpassed the 2004 target by P23.4 billion

FOREIGN DEBT RATIOS



	1997	1998	1999	2000	2001	2002	2003	2004
FOREIGN DEBT/GNP (%)	50.1	67.3	63.6	63.5	68.3	65.6	68.9	60.5
DEBT SERVICE BURDEN (%)	11.6	11.7	14.1	12.4	15.8	16.4	16.9	13.8

*Ratio of debt service payments to merchandise exports and receipts from services and income.

(3.5%), mainly because of better-than-expected returns on Treasury investments and, to a lesser extent, higher-than-targeted Customs collections. The Bureau of Customs (BOC) surpassed its P122.6-billion collection target by P9.9 billion (8.8%), due in part to a weaker local currency and higher-than-projected import bill. The Bureau of Internal Revenue (BIR), which accounts for 80% of Government tax revenues, collected 10.1% more versus 2003 but fell P8.1 billion (1.7%) short of the agency's collection target. Expenditures (P886.8 billion) exceeded the programmed level by P12.6 billion (1.4%) as the Government took advantage of better-than-expected revenue inflows to settle accounts payable.

At the end of 2004, the Government assumed $3.5 billion (P200 billion) of the National Power Corporation's (NPC) $10.5 billion debts, as stipulated in the Electric Power Industry Reform Act (EPIRA) of June 2001. This will raise the NG debt service burden by P18 billion during 2005. Nevertheless, the 2005 fiscal program calls for a reduction in the NG deficit to P180 billion (3.4% of GDP), reflecting estimated incremental revenues from legislation signed on December 23, 2004 to raise excise taxes on tobacco and liquor products (P12.6 billion to P15 billion); an executive order raising tariffs on petroleum imports (P5 billion); and tax-collection improvements (including expected benefits from legislation signed on January 25, 2005 to institute a lateral attrition system in the Government's revenue collection agencies).

The National Government deficit is on track thus far to fall below P180 billion (3.4% of GDP), the ceiling programmed for 2005. The NG deficit of P63.5 billion during 2005's first quarter is P14.3 billion (18.4%) below the programmed level for that period. January-March 2005 revenues expanded by P20 billion to P172.6 billion year-on-year (13.1%) and exceeded the first-quarter target by P9.3 billion (5.7%). Combined collections of the BIR and BOC (P140.9 billion) fell somewhat short of the first-quarter 2005 target by P2.8 billion (1.9%) but higher-than-targeted inflows from Treasury incomes and from government fees and charges were more than offsetting. Meanwhile, disbursements during the first three months of 2005, although up 12.7% year-on-year to P236.1 billion, were P5 billion (2.1%) below the programmed first-quarter level due in part to lower-than-projected borrowing costs. The Government was also functioning under a re-enacted budget during the period, pending Congressional approval of a new P907.6-billion budget President Macapagal-Arroyo signed into law in mid-March 2005. According to more recent estimates, the NG fiscal surplus was P3.3-billion during April 2005, the first surplus in four years.

From P221.7 billion (5.3% of GDP) in 2003, the consolidated public sector deficit (CPSD) — which, in addition to the NG, includes the financial performance of government-owned financial and non-financial corporations, the BSP, local government units, and state-run social security agencies — closed 2004 at P233.5 billion (4.9% of GDP). That deficit was below 2004's targeted P315.9-billion CPSD level mainly because of a smaller-than-expected NG budget gap, lower-than-projected losses of non-financial public sector firms (reflecting low capital investments), and higher-than-targeted surpluses posted by social security agencies.

The current goal for 2005 is to reduce the consolidated public sector deficit to P203.9 billion (3.8% of GDP). While a smaller NG deficit will contribute to a narrower CPSD, the

2005 program mainly reflects a smaller projected net loss for non-financial government corporations, particularly NPC. NPC's net loss is expected to decline from P106 billion during 2004 to P32 billion during 2005. The Government has achieved some success in establishing an independent regulatory system for electricity pricing which will benefit NPC finances. In April 2005, the Philippine Energy Regulatory Commission (ERC) simultaneously released three rulings in response to NPC's petitions for a generation-rate hike and to recover costs from changes in the foreign exchange rate, the cost of fuel, and the cost of energy purchased from Independent Power Producers (IPPs).

Despite recent progress in containing the deficits of the National Government and the consolidated public sector, the high level of public sector debt has made the Philippines increasingly vulnerable to domestic and external shocks. Based on the latest available consolidated data, outstanding debts of the non-financial public sector stood at P4.6 trillion as of end-September 2004, equivalent to 100.2% of Philippine GDP. Nearly 67% of that consolidated debt figure represented foreign currency obligations. More recent data shows the NG debt alone at P3.8 trillion as of end-2004 (equivalent to 78.7% of GDP). Outstanding NG debt rose further to P4.1 trillion as of February 2005, which partly reflected the P200 billion in liabilities assumed from the NPC.

Because of inadequate resources and high debt service requirements, meeting fiscal deficit targets has required tight expenditure control, hindering the efficient delivery of vital social and economic services. Reflecting a history of persistent fiscal deficits, rapid debt accumulation, and the impact of the peso's depreciation on foreign-denominated loan obligations, debt service payments will eat up over a third of the National Government obligation budget of P907.6 billion during 2005. Together with personnel-related costs and mandatory transfers to local government units, "non-discretionary" expenditure items will gobble up more than 80% of the 2005 NG budget, leaving little resources for "discretionary" but essential expenditure items such as infrastructure, programmed outlays for which will equal barely 1.7% of Philippine GDP.

On May 24, 2005 President Macapagal-Arroyo signed legislation that seeks to boost National Government revenues by amending the Philippines' Value Added Tax law. Although controversial, Republic Act (R.A.) 9337, which takes effect in July 2005, represents the most significant measure thus far in Government efforts to raise at least P80 billion in revenues from legislative measures to help avert a fiscal crisis. The Government hopes to raise about P28.8 billion in incremental revenues from R.A. 9337 during the second half of 2005 and over P100 billion during 2006. Although the recently signed law will pinch consumers and the business sector, the Government expects longer-term benefits for the Philippine economy (i.e., better credit ratings, lower borrowing costs, more resources for infrastructure, and stronger investments).

Although the 2005 program has not been changed, the Government plans to use all of 2005's incremental revenues from R.A. 9337 to narrow the NG deficit further. This would translate to a P153-billion budget gap for 2005 (equivalent to roughly 2.8% of GDP) versus the current P180-billion (3.4% of GDP) deficit target. Government officials also expect the consolidated public sector deficit to narrow further from the current P204-billion (3.8% of GDP) goal to Pl78 billion (3.2% of GDP). After 2005, the Government plans to use part of the incrementally increased revenues from the VAT amendments to devote additional resources to capital expenditures, with the latter's share of incremental VAT revenues rising gradually from 30% in 2005 to 50% by 2010. Government officials hope this strategy will increase NG capital expenditures to about 3.3% of GDP by 2010, about double the current ratio. Preliminary Government simulations also project a possible balanced budget by 2008 — two years ahead of schedule — and a reduction in the consolidated public sector deficit to just 0.3% of GDP by 2010. The Government expects the narrowing public sector deficits to contain the pace of debt accumulation so by 2010 the ratios of NG debt and non-financial public sector debt to GDP will decline to about 45% and 55%, respectively.

On the expenditure front, President Macapagal-Arroyo has issued executive orders for Government agencies to adopt fiscal austerity measures and to conduct a strategic review of their operations. She is also seeking legislative support for, among others: (1) a proposed Fiscal Responsibility Act to prevent the enactment of new expenditures without accompanying revenue measures; (2) an Omnibus Re-Engineering Act to authorize a major reorganization/rationalization of the bureaucracy; and (3) legislation limiting or scrapping automatic loan guarantees for Government corporations.

Contingent liabilities (i.e., government-guaranteed loans and performance undertakings under Build-Operate-Transfer and similar arrangements) are a growing concern. Problems have already begun to emerge in this area, in several cases because the Government has bowed to public pressure against service fee adjustments. The risks posed by contingent obligations underscores the urgency of inventorying Build-Operate-Transfer Projects, quantifying potential risks arising from Government commitments, and developing an early-warning mechanism to detect problem areas. The Government faces another important challenge in addressing threats to the longer-term viability of state-run pension funds arising from imbalances between contributions received and benefits paid.

Special Feature:

The Amended Value Added Tax Law: A Bitter Fiscal Pill

On May 24, 2005, President Macapagal-Arroyo signed Republic Act (R.A.) 9337 to raise badly needed revenues by amending the Philippines' Value Added Tax law. The recently signed law takes effect on July 1, 2005.

The executive branch had pushed for a relatively simple measure to raise the VAT rate from 10% to 12% and to narrow the list of VAT-exempt transactions. The more complex measure that emerged from the Philippine legislature keeps the VAT rate at a uniform 10%, as proposed by the Senate. However, as a compromise with the House of Representatives — which had insisted on increasing the rate to 12% — R.A. 9337 mandates the President to raise the rate by two percentage points in 2006 under either of the following conditions: 2005 VAT collections as a percentage of GDP exceeds 2.8%, or the 2005 National Government deficit as a percentage of GDP exceeds 1.5%. Both these conditions have already been met and President Macapagal-Arroyo has announced her readiness to increase the VAT rate to 12% in January 2006. Opposition lawmakers have challenged the new law before the Supreme Court, claiming among others that the standby authority unconstitutionally relegates the legislature's taxing authority to the executive branch.

R.A. 9337 eliminates the VAT-exempt status of certain nonfood agricultural products; the sale or import of coal, natural gas, and petroleum products; the sale or import of raw materials to manufacture petroleum products; the import by transport operators of passenger or cargo shipping vessels of more than 5,000 tons; sales by artists of their literary works, musical compositions, and similar creations; sales by electric cooperatives; and, services rendered by lawyers and doctors of medicine. It also includes the domestic air and sea transport of passengers under the VAT net, in lieu of the franchise or common carriers' tax.

R.A. 9337 subjects to VAT the sales of power generation companies, which are currently zero-rated under the Electric Power Industry Reform Act, as well as the sales of power transmission and distribution companies, which are currently VAT-exempt. (Note: In addition to not paying output VAT, zero-rated transactions are able to refund, or credit against other taxes, VAY paid on inputs. End Note.) Sales of power generated through renewable sources of energy (i.e., biomass, solar wind, hydropower, ocean energy, and other emerging sourcing using technologies such as fuel cells and hydrogen fuels) remain zero-rated. The final legislation signed into law scrapped controversial provisions contained in both the Senate and House bills that would have prevented the power sector from passing the VAT on to their customers. To temper the impact of VAT on fuel and electricity rates, the new law: (1) repeals the 2% franchise tax on electric utilities; (2) reduces the excise tax per liter of regular gasoline to P4.35 (from P4.80); and (3) scraps the excise taxes on bunker fuel, diesel, kerosene, and natural gas.

To compensate for maintaining the VAT rate at 10% in 2005, R.A. 9337 adopted the Senate's proposals to raise revenues from other taxes. It raises the Philippines' already high corporate income tax rate from 32% to 35% until 2008 (after which the rate declines to 30%). Although various business chambers supported an increase in the VAT rate, they warned that the higher corporate tax would hurt the business sector and potentially discourage new investments. The legislation also increases the gross receipts tax from 5% to 7% on certain bank and financial-intermediary revenues, such as royalties, property rentals, and net trading gains on foreign currency, debt securities, derivatives, and similar instruments.

R.A. 9337 also staggers credits on input VAT paid on capital equipment over a five-year period. The telecommunications industry and other capital-intensive sectors opposed this provision as a de facto interest-free loan from the private sector to the Government and as an additional burden on business finances. The new law also imposes a cap on input VAT claims at only 70% of output VAT in any one quarter. Businesses with an "excess" amount of input VAT must carry those claims over to the next quarter. Those companies with continuous carryover, therefore, will not recover the input VAT in full until they cease to operate, effectively absorbing the 30% differential on each and every transaction.

Outstanding loans guaranteed by the Government stood at P607.4 billion as of February 2005, with nearly 95% ($10.5 billion) representing foreign-denominated debt. NPC loans made up the bulk (55%) of guaranteed debts. In addition to having recently assumed part of NPC's obligations, the Government has had intermittently to advance debt service payments for NPC and, over the past several years, to borrow on behalf of the cash-strapped firm to obtain cheaper rates. These illustrate the urgency of moving forward with the restructuring of the power sector and the privatization of the National Power Corporation as a critical component of a sustainable fiscal consolidation plan. The privatization of generation assets is moving slowly. As of May 2005, the Government had privatized 609 megawatts, representing 12% of NPC's generation capacity, and needs to sell another 2,900 megawatts to reach its goal of privatizing 70% of NPC's total capacity by the end of 2005.

In January 2005, six months after the Philippines' most recent downgrade, Standard & Poor's (S&P) cut sovereign credit ratings by yet another notch. In February 2005, Moody's Investors Service, which had last downgraded Philippine sovereign credit ratings in January 2004, lowered the Philippines' ratings by two more notches. The rating agencies expressed continuing concerns over the sustainability of high public sector debt levels and delays in passing major revenue-boosting measures. Reflecting cautious optimism, S&P analysts recently indicated that the agency was not inclined immediately to raise credit ratings after the passage of the amended VAT law but would closely monitor indications of a sustainable fiscal and debt turnaround. A few days after President Macapagal-Arroyo signed the amendments to the VAT law, Fitch Ratings Agency — which last lowered scores for Government bonds in June 2003 — affirmed its ratings but revised the ratings outlook from "negative" (indicating a danger of further downgrades) to "stable."

Various consumer groups continue to oppose the amended VAT law as an additional inflationary burden. While generally supportive of a higher VAT rate and fewer VAT exemptions, business groups and foreign chambers of commerce have expressed concern over specific provisions they consider harmful to profitability and discouraging to investments. Part of the resistance and skepticism reflects public disenchantment with weaknesses in tax administration, waste, and corruption. In the end, effective implementation will be crucial to maximizing the collection and disbursement of the estimated resources from the recently signed legislation and to achieving the longer-term benefits (i.e., macroeconomic stability and improved delivery of Government services) envisioned from this painful but necessary fiscal measure.

Foreign Debt and Debt Service

National Government foreign borrowings totaled $3.5 billion during 2004, $890 million (20%) less than in 2003. To meet foreign debt service obligations and help build up international reserves, the financing program for 2005 envisions raising $4.1 billion from external sources, up $528 million (14.9%) from 2004. That represents 40% of the total domestic and foreign borrowing plan for 2005, somewhat higher than the 34% share of foreign credits obtained the year before. The Government plans to raise $3.1 billion (77%) of the 2005 NG foreign borrowings from overseas bond markets, $274 million more than in 2004. It hopes to obtain the remaining $937 million balance from official development assistance (ODA) loans, $254 million more than 2004 ODA borrowings. As of May 2005, NG borrowings were $2.54 billion in foreign credits — $2.25 billion from commercial sources and $285 million from ODA donors — equivalent to 61% of its full-year 2005 foreign borrowing goal.

The Philippines' recorded external debt (based on public and private sector foreign credits approved and/or registered with the Bangko Sentral ng Pilipinas) stood at $54.8 billion at the end of 2004, a contraction of $2.5 billion (4.4%) from the end of 2003. The public sector's external liabilities declined by $1.6 billion (4.1%), and those of the private sector by $947 million (5.3%). The decline from end-2003 reflected net repayments of foreign obligations (i.e., principal payments exceeded borrowings during the year), as well as higher residents' holdings of Philippine debt papers. Starting in 2004, the BSP has excluded residents' holdings from the estimation of the foreign debt stock, consistent with the international norm.

The public sector owed 69% of the Philippines' outstanding external liabilities as of end-2004. Medium- to long-term (MLT) loans made up more than 90% of the country's total foreign debt portfolio. The MLT loans had an average weighted maturity of 17 years, with public sector loans carrying a longer average maturity (20 years) relative to the private sector (11 years).

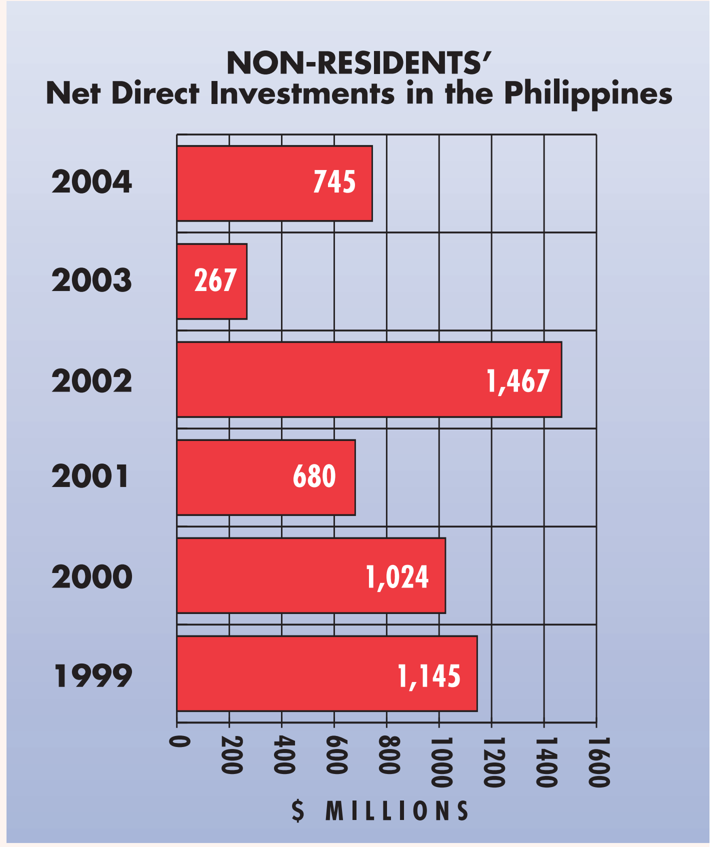
By type of creditor, 46% of the Philippines' external obligations were owed to official lenders (defined as multilateral financial institutions and foreign governments and their export credit agencies) at generally more concessional terms. Bondholders accounted for 28.9%, banks and other financial institutions for 20.4%, and other creditors (mainly suppliers) for 4.7% of the country's external debt stock. The share of debt owed to official lenders has been declining over the years, from 55.3% as of end-1996, just before the onset of the Asian crisis. Conversely, the cumulative share of commercial creditors to the foreign debt stock has risen, from 44.7% to 54% over that same period. The declining share of official development assistance (ODA) reflects project implementation bottlenecks, limited resources for Government counterpart funding, and an increasingly competitive environment for ODA financing. Looking forward, the increasing reliance on commercial credit increases the Philippines' vulnerability to contagion when emerging-market debt is under pressure. Accessing commercial borrowings at affordable rates in more competitive global financial markets will depend on maintaining macroeconomic stability and improving sovereign credit ratings. Although oversubscribed, the National Government's $1.5 billion, 25-year foreign bond issue in late January 2005 carried a spread of about 505 basis points over comparable U.S. Treasury yields.

The ratio of the Philippines' foreign debt stock to GDP declined from 73.9% at the end of 2003 to 64.9% at the end of 2004 — consistent with the year-on-year decline of the estimated debt level and the economy's more robust expansion — but remains above the 48.1% ratio recorded at the end of 1996, before the onset of the Asian financial crisis. Overall, however, the Philippines' ability to meet foreign debt service payments relative to foreign exchange flows remains manageable, reflecting the bias for longer-term borrowings and the still substantial share of ODA loans. The foreign debt service burden — measured as the ratio of debt service to export, services, and income receipts — declined from 16.9% during 2003 to a four-year low of 13.8% during 2004, reflecting a combination of lower debt service outlays and higher current account receipts.

Merchandise Trade and Balance of Payments

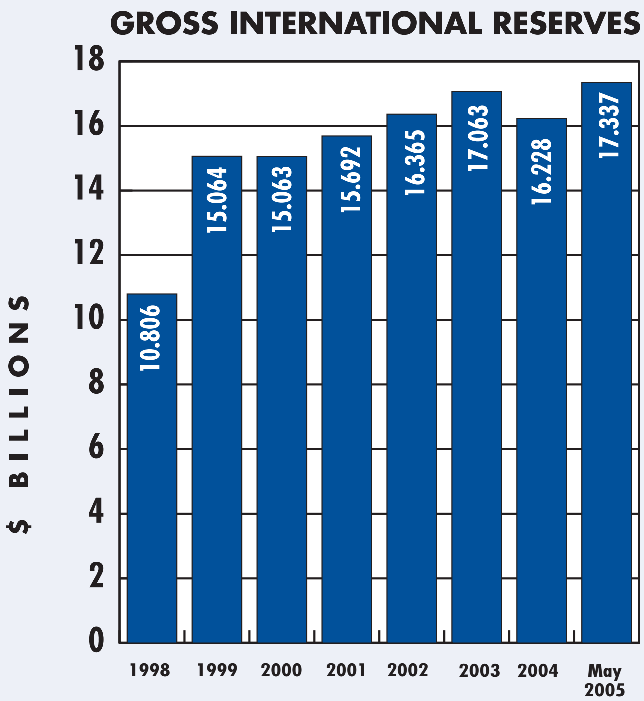
The Philippines' balance of payments (BOP) position reversed from a modest $115 million surplus during 2003 to a $280 million deficit during 2004. The current account surplus widened by 49% ($684 million) from $1.4 billion (1.8% of GDP) to $2.1 billion (2.5% of GDP) but this performance was offset by weak financial and capital flows.

In the current account, the trade-in-goods deficit widened by 17% ($926 million) from $5.5 billion to $6.4 billion as imports (up 10.6%) outpaced exports (up 9.6%). Although exports expanded at a faster pace than the 2.7% growth rate posted during 2003, the Philippines' 2004 performance trailed the robust two-digit growth rates of neighboring Asian economies such as Thailand (23%), Malaysia (20.5%), Singapore (24.2%), Vietnam (30.3%), China (35.4%), South Korea (30.6%), and Hong Kong (15.9%). Meanwhile, the higher import bill mainly reflected larger payments for purchases of raw materials and oil/petroleum products. Sharp increases in world market prices and higher import volumes drove up payments for oil and fuel purchases by 25.2% year-on-year and accounted for a quarter of the total import expansion from 2003.



Exports of electronic products grew by 11.1% during 2004 and contributed over two-thirds to the Philippines' total export revenues, offsetting the decline in earnings from agro/resource-based products and commodities. Revenues from garments exports declined by 4.1% year-on-year, reflecting stiffening competition from China and other emerging economies. By destination, exports within Asia, including Japan, increased by 11.6% ($2.5 billion) and to Europe by 13.1% ($798 million) — more than offsetting the 2.6% ($199 million) decline to North American countries (mainly the United States). Non-Japan Asian economies currently contribute more than 40% to the Philippines' export revenues, up from barely 17% in the early 1990s. Exports to the People's Republic of China (PRC), up by 23.6% during 2004, has expanded at an average annual rate of 37% over the past five years. The PRC's share of total Philippine export revenues increased to 6.7% in 2004, significantly up from barely 1.6% in the late 1990s.

Improvements in the trade-in-services account and other current account transfers during 2004 offset the wider merchandise trade deficit. The services account deficit narrowed by 25.7%, from $1.7 billion (2003) to $1.3 billion (2004) mainly because net travel receipts more than doubled to a $697 million surplus. Crediting intensified promotion efforts, the Department of Tourism report-



ed that full-year 2004 tourist arrivals increased by 20.1%, rebounding strongly from the 1.3% decline logged during 2003. The current account also benefited from the continued expansion of remittances from the Philippines' overseas contract workers. Based on a revised BOP estimation methodology that also seeks to capture remittances in kind as well as remittances coursed through informal channels, the BSP estimates that OFWs remitted more than $11.5 billion during 2004, up by 8.1% ($867 million) from 2003.

The capital and financial account deficit widened further from $1.5 billion in 2003 to $1.7 billion in 2004, reflecting lower net direct investment inflows and larger net outflows of portfolio capital. Net foreign direct investment (FDI) slipped to a smaller $57 million surplus relative to 2003 ($150 million), paling in comparison to East/Southeast Asian neighbors such as China ($60.6 billion), Singapore ($5.4 billion), South Korea ($3.4 billion, Vietnam ($1.7 billion), Indonesia ($1.1 billion), and Thailand ($656 million). Net FDI from non-residents expanded by 35.2% ($122 million) to $469 million, but higher offshore investments by Philippine residents (which expanded from $197 million in 2003 to $412 million in 2004) pulled down the overall FDI surplus. Meanwhile, 2003's $1.3-billion deficit in net portfolio investments widened somewhat to more than $1.4 billion. Net portfolio investments by foreign investors in the stock market and in Philippine debt papers expanded to $517 million, more than thrice 1993's comparable level. However, that expansion was offset by larger offshore portfolio investments by Philippine residents.

The BSP expects more robust flows of foreign portfolio capital, foreign direct investment, tourism receipts, and overseas workers' remittances to push up the full-year 2005 BOP surplus to over $800 million. Although detailed BOP accounts are not yet available, the BSP estimated the Philippines' BOP position as of May 2005 at a surplus of $1.6 billion, more than triple the $477 million surplus as of May 2004. Although first-quarter 2005 exports slowed to 3.6% growth year-on-year, the merchandise trade account emerged with a modest $122 million surplus as imports declined by 3.6%, reflecting a 7.2% year-on-year contraction in the non-fuel import bill. Banking sector reports through April 2005 showed that cash remittances by OFWs through formal channels expanded by 17% year-on-year (higher thus far than the 10% growth rate targeted for the full year). Banks also reported more than $1.8 billion in net foreign portfolio investments by non-residents during the first five months of 2005, 3.5 times the full-year 2004 level. Boding well for travel-related foreign exchange receipts, the Department of Tourism estimated that first-quarter 2005 tourist arrivals expanded by more than 11% year-on-year.

Beyond short-term prospects, longer-term BOP vulnerabilities remain. The Philippines historically has posted trade surpluses during periods of economic weakness, reversing to deficits as economic expansion accelerates. The Philippines is heavily dependent on electronics for its export revenue. The country's major export products rely heavily on imported inputs. While trade liberalization presents vast opportunities, intensifying global competition and the emergence of low-wage export economies also pose challenges. Although currently robust, portfolio investments are prone to quick reversals in sentiment. Longer-term BOP stability will also depend heavily on the Philippines' ability to compete for more non-debt sources of foreign exchange as the Government works to avert heightened risks posed by the rapid debt build-up of previous years.

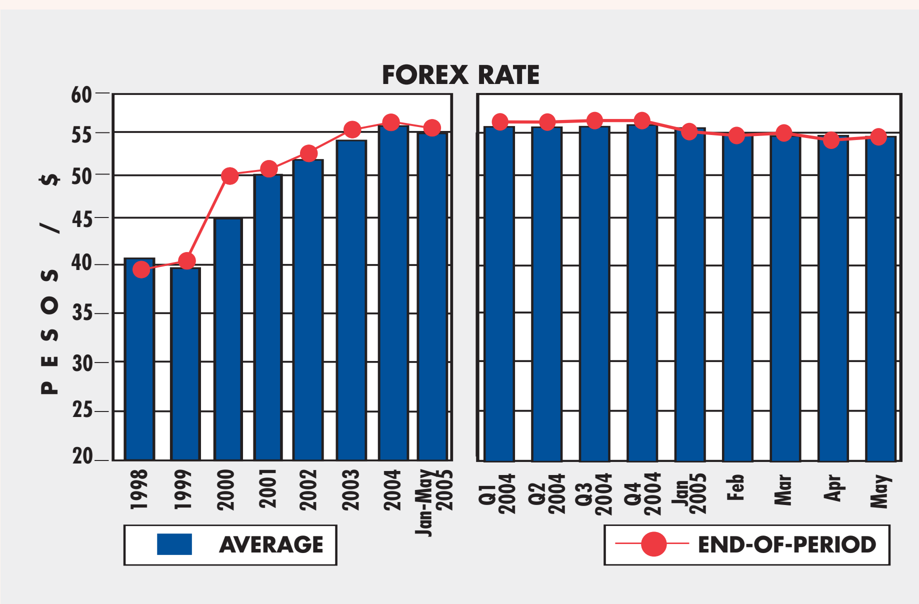
Foreign Exchange Rate and International Reserves

The peso averaged P56.04/$ during 2004, 3.3% weaker than 2003's comparable average of P54.20/$. It closed 2004 at P56.28/$, a 1.4% depreciation from the end of 2003 (P55.50/$). The local currency revisited its historic P56.45/$ intra-day low in late September and also slipped to its weakest-ever closing rate (P56.45/$) in mid-October. Election-related uncertainties, escalating fiscal concerns, credit rating downgrades, and surging world oil prices weighed down the local currency. Although weaker than

2003, however, the peso exhibited less volatility during 2004 and traded within a narrower 2.5% band of P55.06-P56.45/$ (versus 2003's 7.7% range of P51.88-P55.85/$).

The local currency has since appreciated, averaging P54.77/$ during the first five months of 2005. Stronger regional currencies pulled up the peso, as did stronger balance of payments flows and improved perception arising from a number of positive developments, including determined efforts to narrow the public sector deficit, the enactment of revenue-raising laws, a Supreme Court decision upholding the legality of up to full foreign equity participation in mineral exploration activities, and the Philippines' removal from the FATF's money laundering watch list. The peso hit an intra-day high of P53.83/$ on March 17 and closed at its strongest on March 16 (P53.94/$), the highest intra-day and closing rates posted since July 2003. More recently, the peso has come under pressure from some recovery in the U.S. dollar and expectations of further U.S. interest-rate increases. The peso closed at P54.52 in May, 3.1% stronger than at the end of 2004.

The BSP's gross international reserves (GIR) closed each of the months of 2004 below the end of 2003's $17.1 billion cushion and ended 2004 at $16.2, which partly reflected lower foreign borrowings by the National Government and net repayments of foreign obligations by the public and private sectors during that year. The smaller end-2004 international reserve cushion did not translate to a dramatic decline vis-à-vis the Philippines' ability to pay for its import requirements and to service short-term debt servicing obligations. The end-2004 GIR level represented 3.7 months' worth of imports of goods and services, down from 4.1 months of import cover as of end-2003, and was equivalent to 156.5% of public and private sector principal payments falling due in the next 12 months, up from 140.7% as of the end of 2003.



Helped by proceeds from public sector borrowings, the BSP's GIR cushion has since increased to $17.3 billion as of end-May 2005, the highest month-end level recorded since April 2002. That GIR cushion was equivalent to 3.9 months of import cover and to 179.3% of foreign debt obligations falling due through May 2006. The BSP estimated that banks' foreign currency deposit units (FCDUs) had $15.5 billion in deposits at the end of 2004, up 15.8% ($2.1 billion) from 2003. The bulk (94%) of FCDU deposits are from Philippine residents.

Challenges and Prospects

Shortly before her inauguration, President Macapagal-Arroyo outlined a ten-point agenda for economic growth that restated, among others, her commitments to: balance the budget; create more jobs; improve public school educational facilities; expand the delivery of basic services (specifically water and electricity); and, decentralize progress around the nation through improved transportation, telecommunications, and infrastructure networks. These goals were repeated in her July 2004 State of the Nation Address (SONA) and, later in 2004, further articulated in the Government's 2004-2010 Medium-Term Philippine Development Plan (MTDP).

In addition to balancing the National Government budget over the next six years, the MTDP's "fighting targets" include: increasing the GDP growth rate to 7%-8% by 2009/2010; hiking the investment-to-GDP ratio to 28% by 2010; and, reducing poverty incidence to below 20% by 2009. GDP growth has averaged barely 4% over the last 15 years and the economy has had difficulty in sustaining economic growth of over 5%. The investment-to-GDP ratio, estimated at about 24% in the early 1990s, was barely 17% in 2004 — well behind Asian neighbors such as Thailand (27.1%), Vietnam (35.5%), and Malaysia (22.5%), as well as trade competitors such as China (45.6%) and South Korea (29.1%). The Government's latest poverty survey estimates that 28% of families and 34% of the Philippine population live below the poverty line.

Historically weak revenue collections and chronic budget deficits are the cause of many economic problems, including the inadequate infrastructure, the worrisome debt level, the overburdened educational system with eroding English language skills, and the economy's "boom-and-bust" growth pattern. The Government deserves credit for pursuing politically unpopular measures, such as the amended VAT law and market-based electricity pricing, in an effort to address high public sector debt levels while preventing further erosion in capital expenditures and the delivery of social services. There will be substantial public pressure on the Administration to show concrete results for painful fiscal measures. Long-term fiscal viability will also require persistent, parallel efforts to address high tax evasion and leakage rates.

Given the country's low domestic savings rate, the Philippines must work aggressively to attract foreign capital in a fiercely competitive global environment by addressing the worrisome slippage in its competitiveness and corruption rankings relative to its neighbors. The Government has been working to reinvigorate its anti-corruption drive, and the Office of the Ombudsman has reported improved conviction rates. Despite recent progress, however, the Philippines will need to do more to improve international perception of its anti-corruption campaign — an effort that will require strong political will and significantly greater financial and human resources.

The Philippines hopes to receive assistance for anti-corruption and other developmental programs under the United States' Millennium Challenge Account (MCA). In November 2004, the U.S. Millennium Challenge Corporation (MCC) designated the Philippines as one of twelve candidates for the MCA's FY 2005 Threshold Program. The Threshold Program is intended to assist countries that have demonstrated a commitment to reform but that require additional policy progress in certain areas to qualify for core MCA funding. The Philippines submitted a concept paper in March 2005 outlining proposals for policy, regulatory, and institutional reforms to strengthen areas of weakness in transparency and governance, fiscal stability, and expenditures on health. At the request of the MCC, the Philippines is refining its proposal. If the MCC approves the concept paper, the Philippines will be asked to submit a detailed Threshold Country Plan. The MCC will make the final determination whether to fund a given Plan and what funding level to provide.

Over the years, the Philippines has demonstrated considerable resilience and prided itself as the least adversely affected Southeast Asian country during the Asian financial crisis. With its neighbors rebounding strongly, however, the challenge for the Philippines is to compete effectively for trade and capital in a rapidly globalizing world economy. In addition to fiscal reform, attracting higher levels of foreign and local private investments remains critical to meeting development goals, improving the inadequate state of Philippine infrastructure, addressing high unemployment, and sustaining a higher economic growth path.

PROJECTIONS FOR 2005: SELECTED INDICATORS

	2003 Actual	2004 Actual	2005 Forecast a/
GDP Growth (Year-on-Year, %)	3.6	6.1	4.7-5.1
GNP Growth (Year-on-Year, %)	4.0	6.2	4.9-5.3
Average Year-on-Year Inflation (1994=100, in %)	3.5	6.0	7.6-8.1
Average 91-day T-bill Rate (%)	6.03	7.34	6.5-7.0
Average Forex Rate (Pesos/US$)	54.20	56.04	54.90-55.50
Exports ($Billions)	35.3	38.7	40.8-41.2
Growth (Year-on-Year, %)	b/	9.6	5.5-6.5
Imports ($Billions)	40.8	45.1	46.9-47.3
Growth (Year-on-Year, %)	b/	10.6	4.0-5.0
Trade Balance ($Billions)	(5.5)	(6.4)	(6.1)

a/ Embassy projections as of June 2005.

b/ In March 2005, the Philippine Government released revised statistics to reflect BOP data/methodology improvements (including efforts to reflect under-reporting of consigned imports used for electronics manufacturing). Revised trade figures prior to 2003 have yet to be released and comparable export and import growth rates for 2003 and earlier are, therefore, not yet available. Based on the unrevised data series, exports and imports expanded by 2.8% and 6.4%, respectively, in 2003.

Sources: National Economic and Development Authority, Bureau of Treasury, Bangko Sentral ng Pilipinas.

PHILIPPINES: KEY ECONOMIC INDICATORS

(In Million USD, unless otherwise noted)

	2003	2004	2005	p/
Domestic Economy				
Population (millions)	82.0	83.9	85.9	
Population growth (%)	2.36	2.36	2.36	
GDP (current) ***a/***	77,685	84,567	22,074	Jan-Mar
GNP (current) ***a/***	83,190	90,656	23,661	Jan-Mar
Per Capita GDP, current dollars ***a/***	947	1,008	257	Jan-Mar
Real Per Capital GDP (% change, yr.-on-yr.)	1.2	3.7	2.2	Jan-Mar
Real GDP (% change, yr.-on-yr.)	3.6	6.1	4.6	Jan-Mar
Real GNP (% change, yr.-on-yr.)	4.3	5.6	6.1	Jan-Mar
Consumer Price Index (ave. % change, yr.-on-yr. (2000=100)	3.5	6.0	8.5	Jan-May
Production, Employment, Fiscal Accounts				
Unemployment rate (%) b/	11.4	11.8	11.3	Jan
Industrial prod. (1985=100), % change yr.-on-yr.	3.8	5.2	4.2	Jan-Mar
Nat'l gov't budget surplus/(deficit) ***a/***	(3,688)	(3,338)	(1,096)	Jan-Apr
as % of GDP	(4.7)	(3.9)	(3.7)	Jan-Apr
Consolidated public sector surplus/(deficit) ***a/***	(4,090)	(4,166)	—	
as % of GDP	(5.3)	(4.9)	—	
Interest Rates (%)				
Weighted average T-bill rate (all maturities)	6.7	8.1	6.8	Jan-May
Average prime loan rate	8.9	10.1	9.6	Jan-May
Balance of Payments				
Exports (FOB)	35,342	38,728	9,520	Jan-Mar
Growth (%, yr.-on-yr.)	g/	9.6	3.6	Jan-Mar
Imports (FOB)	40,797	45,109	9,397	Jan-Mar
Growth (%, yr.-on-yr.)	g/	10.6	(3.6)	Jan-Mar
Trade balance	(5,455)	(6,381)	123	Jan-Mar
Current account surplus (deficit)	1,396	2,080	—	
as % of GNP	1.7	2.3	—	
BOP surplus/(deficit)	115	(280)	1,630	Jan-May
Foreign Debt, as of end of period *c/*	57,395	54,846 d/	—	
Debt service paid	7,967	7,221	826	Jan
Debt service (% of exports of goods and services)	16.9	13.8	—	
BSP International Reserves, as of end of period	17,063	16,228	17,337	May
Exchange Rate (pesos/$)				
Average exchange rate	54.20	56.04	54.77	Jan-May
Closing exchange rate	55.50	56.28	54.52	May
Foreign Direct Investment (BSP registrations) *e/*				
Total (cumulative, since 1973)	16,587	17,267	17,281	as of Feb
U.S. (cumulative, since 1973)	3,525	3,565	3,569	as of Feb
U.S. share (%)	21.3	20.6	20.7	as of Feb
U.S.-Philippine Trade (Phil. Data)				
Philippine exports to U.S., FOB ***f/***	7,263	7,079	1,668	Jan-Mar
Growth (%, yr.-on-yr.)	(16.4)	(2.5)	6.5	Jan-Mar
Philippine imports from U.S., FOB ***f/***	7,400	6,584	1,456	Jan-Mar
Growth (%, yr.-on-yr.)	1.6	(11.0)	(17.2)	Jan-Mar
Philippine trade balance with U.S. ***f/***	(137)	495	212	Jan-Mar
U.S. share of Philippine imports (%)	18.2	14.7	15.5	Jan-Mar

a/ originally peso values, converted to USD; ***b/*** annual figures computed as average of quarterly surveys (Jan/Apr/Jul/Oct); ***c/*** excludes "net due to" accounts of foreign commercial banks and private sector loans not approved and/or registered by/with the BSP; ***d/*** 2004 data reflects refinements in segregating debt held by residents (which are excluded from foreign-debt estimates); ***e/*** principally exercised to enable foreign exchange purchases from the banking system for capital repatriation and profit remittances; ***f/*** differs from USG data which estimated the Philippines' trade surplus with the U.S. at $2.1 billion in 2003, $2.1 billion in 2004, and $574 million during January-March 2005; ***g/*** trade numbers revised to reflect improvements in coverage/data gathering (especially to address under-reporting of consigned imports for export production) but comparable revised numbers prior to 2003 are not yet available; ***p/*** preliminary

Sources: National Economic and Development Authority; Department of Finance; Bureau of the Treasury; Bangko Sentral ng Pilipinas